

# **Mandatory Registration of Hedge Funds with the SEC and Hedge Fund Activism in Corporate Decision-Making**

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*The hedge fund industry has grown exponentially in the past five years and is now an increasingly important part of the national economy. In response to this growth, the Securities and Exchange Commission recently implemented a rule requiring certain hedge fund advisors to register with the Commission. The first section of this Note takes an in depth look at whether the Commission had the legal authority to make the rule, whether the rule is necessary, and whether the rule will be effective in achieving the goals of gathering information and deterring fraud.*

*The second section of this Note examines some recent investment strategies hedge fund advisers have utilized to maximize return on investment. Specifically, the Note analyzes how certain hedge fund advisers have used proxy contests to oust incumbent directors and influence corporate strategy while avoiding corporate anti-takeover devices.*

## **I. INTRODUCTION**

The hedge fund industry has grown exponentially in the past five years and is now an increasingly important part of the national economy. The growth and development of the hedge fund industry is catching the attention of the Securities and Exchange Commission (“SEC”) and is now leading to unique investment strategies that have never before been utilized.

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This Note takes an in-depth look at the SEC's response to the increasing growth of the hedge fund industry and also examines some recent investment strategies hedge fund advisers have utilized to influence corporate strategy.

The first section of this paper analyzes the recent rule adopted by the SEC that requires the registration of certain hedge fund advisers with the SEC, subjecting these advisers to various reporting requirements, compliance requirements, and potential examination by the SEC. The primary concerns here are whether the SEC has the legal authority to adopt such a rule, whether such a rule is necessary, and whether the rule will be effective in achieving the SEC's goals of gathering information and deterring fraud.

The second section of this Note examines a category of hedge fund investing that pursues corporate policy changes in order to create returns for the investment. What makes this method of hedge fund activity unique is the way in which fund managers utilize long-standing investment techniques. Meanwhile, these fund managers are able to maneuver around a Shareholders' Rights Plan and initiate a successful proxy contest to influence dissenting management. To analyze how hedge funds are utilized in this manner, however, it is first necessary to have a general understanding of hedge funds. The following section provides a basic description.

## II. WHAT ARE HEDGE FUNDS?

Hedge funds have no statutory or regulatory definition, but they do have some common characteristics. Generally, hedge funds are "sophisticated pools of assets that are not marketed and are typically open only to wealthy investors."<sup>1</sup> Professional investment managers, who have a significant stake in the funds they manage and receive a management fee, including a substantial share of the performance of the fund, usually organize them.<sup>2</sup> Because adviser fees are tied to the performance of the fund, there is a greater incentive for advisers to use risky investment techniques to enhance the fund's performance, thus boosting their fees.<sup>3</sup> Furthermore, hedge funds have typically been organized and operated in a way that avoids regulation under the Investment Company Act of 1940.<sup>4</sup>

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<sup>1</sup> Stephen Labaton, *Judges Weigh Hedge Funds vs. the S.E.C.*, N.Y. TIMES, Dec. 10, 2005, at C1.

<sup>2</sup> William Fung and David A. Hsieh, *A Primer on Hedge Funds*, 6 J. OF EMPIRICAL FIN. 309, 310 (1999).

<sup>3</sup> See Jonathon H. Gatsik, Note, *Hedge Funds: The Ultimate Game of Liar's Poker*, 35 SUFFOLK U. L. REV. 591, 595 (2001) (referring solely to the use of leverage for enhancing fund performance, but the same reasoning supports any investment technique which relies upon the fund increasing risk to increase profit).

<sup>4</sup> See 15 U.S.C. §§ 80a-3(c)(1), 80a-3(c)(7) (2004).

Hedge funds were originally designed to invest in equity securities and used leverage and short selling to “hedge” the portfolio’s exposure to movements in equity markets.<sup>5</sup> But today, hedge funds use a wide variety of methods designed to maximize returns.<sup>6</sup> Examples of such methods are shorting stocks and bonds and investing in convertible securities, futures, and options.<sup>7</sup> An in-depth discussion of a variety of different hedge fund investment strategies is, however, beyond the scope of this paper. Rather, our analysis begins with the recent rule by the SEC requiring the registration of certain hedge fund advisers.

### III. DOES THE SEC HAVE THE AUTHORITY TO REQUIRE REGISTRATION OF HEDGE FUND ADVISERS, AND IF SO ... SHOULD IT?

#### A. Background

##### 1. Statutory Context

The Investment Adviser Act of 1940 (“Advisers Act”) has several basic requirements for certain investment advisers that meet established thresholds: registration with the SEC, maintenance of certain business records, delivery of a disclosure statement to clients<sup>8</sup>, and a prohibition from defrauding clients due to a fiduciary duty to act in the best interests of clients.<sup>9</sup> Section 203(b)(3) of the Advisers Act exempts from registration those investment advisers who have had fewer than fifteen clients during the preceding twelve months, do not hold themselves out generally to the public as investment advisers, and are not advisers to any registered

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<sup>5</sup> See Carol J. Loomis, *Hard Times Come to the Hedge Funds*, FORTUNE, Jan. 1970, at 10.

<sup>6</sup> See Bernstein Wealth Management Research, *Hedge Fund Myths and Realities* (Oct. 2002) at 3-4, available at [https://www.bernstein.com/CmsObjectPC/pdfs/non-indexed/HF\\_MythRealities\\_0210.pdf](https://www.bernstein.com/CmsObjectPC/pdfs/non-indexed/HF_MythRealities_0210.pdf).

<sup>7</sup> See, e.g., The Presidents Working Group on Financial Markets, Report on Hedge Funds, and the Lessons of Long-Term Capital Management (1999) [hereafter Working Group], at 4. (Convertible securities are investment contracts which contain a convertible feature to a specified security ex ante.) See BODIE ET AL., INVESTMENTS 54-57 MCGRAW-HILL IRWIN (6th ed. 2005). Options are a contract right, allowing the purchaser the right but not the obligation to buy an asset (call) or sell an asset (put) at a predetermined price on or before a specified expiration date. Futures contracts call for delivery of an asset (or in some case, its cash value) at a specified delivery or maturity date for an agreed-upon price.

<sup>8</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, 72054 (Dec. 10, 2004) (to be codified at C.F.R. pt. 275).

<sup>9</sup> SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963).

investment company.<sup>10</sup> Those eligible for exemption still must comply with the SEC's antifraud provision, but need not file registration forms identifying themselves, maintain business records in accordance with SEC rules, adopt compliance programs or codes of ethics, or subject themselves to SEC oversight.<sup>11</sup> Importantly, the SEC lacks authority to conduct § 204 examinations of exempt advisers.<sup>12</sup>

Until recently, this exemption was utilized by hedge fund advisers to avoid registration with the SEC under the "fifteen client" exception, as the word "client" was interpreted to mean an investment pool rather than an individual investor.<sup>13</sup> But the recent release of the SEC rule "Registration Under the Advisers Act of Certain Hedge Fund Advisers" changes the original interpretation of "client" as it pertains to hedge fund advisers.<sup>14</sup> As a result of the recent release, most hedge fund advisers will no longer be exempt under § 203(b)(3) and will be required to register with the SEC.<sup>15</sup> The effective date of the new rule is February of 2006.<sup>16</sup>

## 2. The Process of the Rule Release

In 2002, the SEC requested a staff investigation of hedge funds because of concerns due to: (1) the growth of hedge funds, (2) increased involvement of hedge funds in fraud, and (3) broader investment in hedge funds.<sup>17</sup> After receiving the findings from this investigation, the SEC proposed a rule in July 2004 requiring hedge fund advisers to count each individual investor in a hedge fund, rather than the hedge fund itself, as a client for purposes of the private adviser exemption.<sup>18</sup> The proposed rule was designed to extend the protections afforded by the Advisers Act to investors in hedge funds and to generally enhance the SEC's ability to protect the nation's securities markets.<sup>19</sup>

The SEC requested and received letters from 161 commentators regarding the rule proposal, including investors, hedge fund advisers, other

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<sup>10</sup> 15 U.S.C.A. § 80b-3(b)(3) (2002).

<sup>11</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72054.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 72054-72055.

<sup>14</sup> *Id.* at 72058.

<sup>15</sup> *Id.*

<sup>16</sup> See Labaton, *supra* note 1, at C1.

<sup>17</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72055.

<sup>18</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72058.

<sup>19</sup> *Id.*

investment advisers, trade associations, and law firms.<sup>20</sup> Forty-two of the commentators were neutral regarding the proposal and offered insights into specific issues<sup>21</sup>, thirty-six commentators (including some hedge fund advisers) supported the proposal,<sup>22</sup> and eighty-three commentators (including many unregistered hedge fund advisers) argued strongly against the proposal, citing concerns about costs of compliance,<sup>23</sup> questionable effectiveness in preventing fraud,<sup>24</sup> and the potential intrusiveness of the oversight of hedge fund managers.<sup>25</sup> In addition, some investors voiced concern that advisers would pass the costs of registration onto them in the form of increased management fees.<sup>26</sup>

On December 10, 2004, in a 3-2 decision, the SEC, led by its chairman William H. Donaldson, released the final rule requiring certain hedge funds to register with the SEC, with an effective date of February 10, 2006.<sup>27</sup> The release of this rule has sparked much debate over whether the SEC has the authority to make such a rule, whether the rule is necessary, and whether the rule will be effective.

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<sup>20</sup> Comments on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, <http://www.sec.gov/rules/proposed/s73004.shtml> (last modified Mar. 21, 2005).

<sup>21</sup> See, e.g., Letter from Van Hedge Fund Advisers to Jonathan G. Katz, Secretary of the SEC (Sept. 15, 2004), available at <http://www.sec.gov/rules/proposed/s73004/van091504.pdf>.

<sup>22</sup> See, e.g., Letter from Ohio Public Employees Retirement System to Jonathan G. Katz, Secretary of the SEC (Aug. 6, 2004), <http://www.sec.gov/rules/proposed/s73004/opers080604.pdf>; Letter from New Jersey State Investment Council to Jonathan G. Katz, Secretary of the SEC (Sept. 17, 2004), <http://www.sec.gov/rules/proposed/s73004/oskramer091704.pdf>.

<sup>23</sup> See, e.g., Letter from Managed Funds Association to Jonathan G. Katz, Secretary of the SEC (Sept. 15, 2004), <http://www.sec.gov/rules/proposed/s73004/jggaine091504.pdf>; Letter from Madison Capital Management, LLC to Jonathan G. Katz, Secretary of the SEC (Sept. 15, 2004), <http://www.sec.gov/rules/proposed/s73004/bgordon091504.pdf>.

<sup>24</sup> See, e.g., Letter from Chamber of Commerce of the United States of America to Jonathan G. Katz, Secretary of the SEC (Sept. 15, 2004), <http://www.sec.gov/rules/proposed/s73004/dhirschmann091504.pdf> ("Letter from Chamber of Commerce"); Letter from International Swaps and Derivatives Association to Jonathan G. Katz, Secretary of the SEC (Sept. 15, 2004), <http://www.sec.gov/rules/proposed/s73004/rgpickel091504.pdf> ("Letter from ISDA").

<sup>25</sup> See, e.g., Letter from Chamber of Commerce, *supra* note 24; Letter from ISDA, *supra* note 24.

<sup>26</sup> See, e.g., Letter from John Waller to Jonathan G. Katz, Secretary of the SEC (July 31, 2004), <http://www.sec.gov/rules/proposed/s73004/jwaller6479.htm>; Letter from Melissa Kadiri to Jonathan G. Katz, Secretary of the SEC (Sept. 15, 2004), <http://www.sec.gov/rules/proposed/s73004/makadiri2294.htm>.

<sup>27</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72054, 72076.

*B. The SEC's Legal Authority Under the Advisers Act*

At issue is whether it is appropriate for the SEC to reinterpret the meaning of the word “client” in the Advisers Act in relation to hedge funds so that each individual investor in a fund, rather than the fund itself, will be considered a “client” for the purposes of the Act. The statutory interpretation of an administrative body, such as the SEC, is entitled to deference when a statute is ambiguous.<sup>28</sup> But if the intent of Congress is clear on the precise question at issue, the agency and the courts must give effect to the unambiguously expressed intent of Congress.<sup>29</sup> The final authority on matters of statutory construction is the judiciary,<sup>30</sup> and if a court determines that Congress had an intention on the precise matter at issue, the court must give effect to that intention as law.<sup>31</sup> The court must reject any interpretation by an administrative body that is contrary to the clear intent of Congress.<sup>32</sup> Here, the relevant issue is whether Congress has unambiguously spoken to the precise issue at question: the meaning of the word “client” in the § 203(b)(3) exemption of the Advisers Act.

The SEC's basic argument to justify its interpretation is that the new rule is consistent with the intent of Congress in enacting the § 203(b)(3) exemption, which was to create a limited exemption for advisers whose activities were not national in scope and who provided advice to family members or friends.<sup>33</sup> Due to the recent growth of the hedge fund industry, the activities of hedge fund advisers are now national in scope and should arguably no longer qualify for this exemption. The term “client” is not defined in the Act, nor does the word have one clear meaning.<sup>34</sup> Therefore, to the extent § 203 is ambiguous, the SEC has the authority to interpret an exemption and adopt a rule that is reasonably related to the statutory purpose.<sup>35</sup>

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<sup>28</sup> *Chevron, U.S.A. v. Natural Res. Def. Council*, 467 U.S. 837, 843-44 (1984) (citation omitted).

<sup>29</sup> *Id.*

<sup>30</sup> *FEC v. Democratic Senatorial Campaign Committee*, 454 U.S. 27, 32 (1981) (citation omitted).

<sup>31</sup> *Lechmere, Inc. v. NLRB*, 502 U.S. 527, 536-37 (1992).

<sup>32</sup> *SEC v. Sloan*, 436 U.S. 103, 117-18 (1978) (citation omitted).

<sup>33</sup> *See, e.g.*, Letter from Wilmer Cutler Pickering Hale and Dorr, LLP to Jonathan G. Katz, Secretary of the SEC (Sept. 8, 2004), <http://www.sec.gov/rules/proposed/s73004/wilmer090804.pdf> (“Letter from Wilmer Cutler”); Letter from Managed Funds Association, *supra* note 23.

<sup>34</sup> *See* WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY (2002) at 422 (“client” means “a person under the protection of another” or “a person who engages the professional advice or services of another”).

<sup>35</sup> *See, Chevron* at 843-44.

### 1. The Applicability and Effect of *Lowe*

Those opposed to the new rule argue that Congress made it clear in 1940 that it intended to exempt from registration an adviser to one or more funds, each of which was to count as only a single “client”, and if that principle is now to be replaced by a “look through” regime, only Congress has the authority to make that change.<sup>36</sup> Several dissenting commentators argue that the SEC is without statutory authority to make this amendment, citing *Lowe v. S.E.C.*, 472 U.S. 181, 210 (1985), in support of their argument. In *Lowe*, the Court held that a publisher of a securities newsletter was not an investment adviser under the Advisers Act because he did not offer “individualized investment advice attuned to any specific portfolio or to any client’s particular needs.”<sup>37</sup> In the *Lowe* decision, the Supreme Court relied heavily on the Investment Advisers Report, a 1939 Commission report that led to the Advisers Act in 1940. In this report, the term “investment adviser” meant a professional who provided individualized services to a client.<sup>38</sup>

Although *Lowe* offers a judicial interpretation of the Advisers Act, it only deals implicitly with the definition of the term “client” in the Act. Instead, the focus of the Court in *Lowe* was with the definition of “investment adviser.” Therefore, it is arguable that a different interpretation of the word “client” by the SEC as proposed in the new rule is not inconsistent with *Lowe*, as *Lowe* dealt only with the definition of the term “investment adviser” and did not speak specifically to the interpretation of the term “client” in the Advisers Act.

Furthermore, even if *Lowe* is found to be applicable to the definition of “client,” the SEC may still argue that many hedge fund advisers now give individualized investment advice to their investors.<sup>39</sup> For example, some hedge fund investors may have greater access to risk and portfolio information, may be provided different lock-up periods, and may be able to negotiate lower fees compared to other investors in the same fund.<sup>40</sup> “Side pockets,” in which assets are segregated, may operate to provide different investors with different investment experiences.<sup>41</sup> Today, each account of a hedge fund investor may bear many resemblances of

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<sup>36</sup> Letter from Wilmer Cutler, *supra* note 33.

<sup>37</sup> See *Lowe v. S.E.C.*, 472 U.S. 181, 208 (1985).

<sup>38</sup> *Investment Management, Investment Supervisory, and Investment Advisory Services, Hearings on H.R. 10065 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 76<sup>th</sup> Cong., 2d Sess. 26-27 (1939) (statement of James White of Scudder, Stevens and Clark).

<sup>39</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72069.

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

separate investment accounts, which would typically be counted as separate clients per § 203(b)(3). Therefore, even if the reasoning in *Lowe* is applied to hedge fund advisers, the new rule may still be found to be permissible in light of the individualized treatment of some hedge fund investors.

## 2. Amendments to the Advisers Act, the Safe Harbor of 1985, and Section 3(c)(7) of the Investment Company Act

Dissenters argue that as Congress occasionally amended the Advisers Act, it did so in a way that reiterated its understanding that a fund counts only as a single client. The reasoning follows that if this principle is now to be replaced by a “look-through” regime, it is up to Congress to make that change. The SEC counters, however, by asserting that the legislative history of the 1980 Amendment supports “looking through” investment vehicles because Congress deliberately left open the question of how to count clients for entities.<sup>42</sup> Language from the House Report indicates that the 1980 Amendment is “not intended to suggest that each shareholder, partner or beneficial owner of a company advised by such a person or firm should or should not be regarded as a client of that person or firm.”<sup>43</sup>

The opposition’s argument that Congressional acquiescence throughout various amendments to the Advisers Act is the equivalent of a Congressional mandate to maintain the current definition of “client” is not particularly persuasive. Moreover, Congressional silence regarding the definition of the term “client” throughout various amendments is not highly determinative that Congress was adamant about maintaining the current definition of “client” in the Act.

Dissenters argue that the SEC itself has consistently understood the word “client” not to cover fund investors who were not themselves advisees, as evidenced by the SEC’s adoption of Rule 203(b)(3)-1 (the Safe Harbor of 1985), which explicitly exempted hedge funds from registration.<sup>44</sup> Yet the SEC stated when it proposed the Safe Harbor of 1985 that “a different approach could be followed in counting clients.”<sup>45</sup> Because of the change in capital markets and the exponential growth of hedge funds, the SEC asserts that reexamination is now appropriate.<sup>46</sup>

Dissenters also argue that the legislative history of § 3(c)(7) of the Investment Company Act indicates that Congress understood there would be potentially large asset pools that would not be required to register with

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<sup>42</sup> H.R. REP. NO. 96-1341, at 62-63 (1980).

<sup>43</sup> *Id.*

<sup>44</sup> Definition of “Client” for Purposes Relating to Limited Partnerships, 50 Fed. Reg. 8740 (proposed July 7, 1985) (to be codified at 17 C.F.R. pt. 275).

<sup>45</sup> *Id.*

<sup>46</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72068.



the SEC.<sup>47</sup> Congress made the formation of large private pools easier by adding § 3(c)(7) (the National Securities Markets Improvement Act of 1996) to the Investment Company Act. This Act permits the formation of unregistered pools of an unlimited number of qualified, or highly sophisticated, investors. Congress passed this Act<sup>48</sup> in recognition of “the important role these pools can play in facilitating capital formation for U.S. companies.”<sup>49</sup> The Committee report faulted “regulatory restrictions on these private pools” for driving American investors offshore.<sup>50</sup> Dissenters argue that Congress was well aware that many advisers to such pools were not registered under the Advisers Act and that allowing them to continue in their unregistered state was entirely consistent with Congress’ objective of minimizing regulatory restrictions on such pools of assets.<sup>51</sup>

Although the legislative history from the National Securities Markets Improvement Act of 1996 indicates that Congress was aware of the important role that these asset pools play in the United States economy, the retailization of hedge funds has changed the premise upon which § 3(c)(7) was based. The notion that highly sophisticated investors are not in need of regulation and protection by the SEC (because they are capable of protecting themselves through their own expertise and resources) is the basis for Section 3(c)(7). Since 1996, however, evidence suggests that retailization of hedge funds has begun in the United States (and has been occurring abroad for several years)<sup>52</sup> and less-sophisticated investors will likely gain access to hedge fund investments. Thus, SEC regulation may be deemed necessary to protect these less-sophisticated investors from the risks and fee structures of hedge funds.

Given the retailization of hedge funds, it is not clear that requiring the registration of hedge fund advisers is contrary to the intent of Congress in its enactment of § 3(c)(7). Moreover, the addition of § 3(c)(7), which excludes funds with sophisticated investors from the definition of an “investment company,” does not necessarily preclude the SEC from interpreting the term “client” in the Advisers Act in a way that would require registration of hedge funds.

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<sup>47</sup> *Investment Trusts and Investment Companies: Hearing on S. 3580 Before a Subcomm. of the S. Comm. on Banking and Currency*, 76<sup>th</sup> Cong. 179 (1940) (statement of David Schenker, Chief Counsel of the Investment Trust Study).

<sup>48</sup> 15 U.S.C. 80a-3(c)(7) (2004).

<sup>49</sup> S. Rep. No. 104-293, at 10 (1996).

<sup>50</sup> *Id.*

<sup>51</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72097.

<sup>52</sup> Silvia Ascarelli and David Reilly, *Hedge Funds Are Coming to the Masses*, WALL ST. J., Apr. 15, 2004.

### 3. The Policy Behind the Rule

Perhaps after all of the debate surrounding the legislative interpretation of the Advisers Act, what is more important is to give the SEC the tools necessary to detect financial fraud and misappropriation.<sup>53</sup> The SEC has broad rulemaking authority under § 211(a) of the Advisers Act to make rules “necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this subchapter . . .” and “may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters.”<sup>54</sup> Section 206(4) of the Advisers Act grants the SEC broad authority to adopt rules that “define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.”<sup>55</sup>

Ultimately, the courts will decide whether the SEC’s recent rule will be permitted to stand. Phillip Goldstein, a hedge fund adviser from Pleasantville, NY; Opportunity Partners, a hedge fund partnership; and its general partner, Kimball & Winthrop have filed a lawsuit maintaining that the SEC exceeded its authority in releasing the new rule.<sup>56</sup> The United States Court of Appeals for the District of Columbia is currently hearing the case.<sup>57</sup> Presuming that the SEC will be found to have the authority to make the rule, the questions then become whether the rule is necessary and whether it will be effective.

#### C. The Need for SEC Action

##### 1. Growth of Hedge Funds

The SEC claims that the size and growth of the hedge fund industry has brought about the need for the new rule. For example, estimates indicate that the hedge fund industry has grown from about \$50B in assets in 1990 to nearly \$1T in assets today.<sup>58</sup> Although some of the growth is

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<sup>53</sup> Labaton, *supra* note 1, at C1.

<sup>54</sup> 15 U.S.C. § 80b-11(a) (1940).

<sup>55</sup> 15 U.S.C. § 80b-6(4) (1940).

<sup>56</sup> See Labaton, *supra* note 1, at C1.

<sup>57</sup> In what many would call a surprising opinion, the United States Court of Appeals for the District of Columbia recently rejected the SEC’s hedge fund rule as arbitrary and unreasonable in light of the clear intent of Congress in the Advisers Act. *Goldstein v. S.E.C.*, No. 04-1434 (C.A.D.C. June 23, 2006), <http://pacer.cadc.uscourts.gov/docs/common/opinions/200606/04-1434a.pdf>. The SEC is currently evaluating its strategy in light of the Court’s decision, and it is not yet clear whether the SEC will petition the decision to the United States Supreme Court.

<sup>58</sup> See Amey Stone, *Hedge Funds Are Everyone’s Problem*, BUSINESSWEEK, Aug. 6, 2004, available at [http://www.businessweek.com/bwdaily/dnflash/aug2004/nf2004086\\_0880\\_db042.htm](http://www.businessweek.com/bwdaily/dnflash/aug2004/nf2004086_0880_db042.htm).

attributed to performance, the majority of the growth is from new capital.<sup>59</sup> The industry is growing faster than that of mutual funds and already equals over one-fifth of the total equity of mutual funds.<sup>60</sup>

Dissenters of the rule argue that the \$1T in assets estimated by the SEC is still dwarfed by the approximately \$23T currently under management by registered advisers.<sup>61</sup> Moreover, dissenters argue that the SEC should not necessarily increase its regulatory requirements on an industry simply because it has grown.<sup>62</sup>

## 2. Growth in Hedge Fund Fraud

Over the last five years, the SEC has brought fifty-one cases of hedge fund adviser fraud with aggregate amounts in issue exceeding \$1.1B.<sup>63</sup> Dissenters argue that many of those implicated in these cases have too few assets to require registration; therefore the new rule would not have had a significant deterring effect on this fraud.<sup>64</sup> Although registration would only cover roughly half of those violations due to a \$30M in assets floor, it would cover \$1B, or almost the entire amount of the fraud.<sup>65</sup>

Opposing commentators quoted the 2003 Staff Hedge Fund Report indicating that investigators found no evidence that hedge fund advisers engaged *disproportionately* in fraudulent activity relative to other investment advisers.<sup>66</sup> For example, only three percent of all actions brought by the SEC and the Commodity Futures Trading Commission in 2003 were against hedge funds or their advisers.<sup>67</sup> But this report was prepared before the discovery of hedge fund involvement in the mutual fund market timing scandal, in which the SEC identified 389 hedge funds

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<sup>59</sup> *Id.*

<sup>60</sup> See ICI Statements and Publications, Investment Company Institute, Mutual Funds Hold 22 Percent Share of U.S. Retirement Market Assets (June 22, 2004), [http://www.ici.org/statements/nr/2004/04\\_news\\_retire\\_fund.html#TopOfPage](http://www.ici.org/statements/nr/2004/04_news_retire_fund.html#TopOfPage).

<sup>61</sup> See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72093.

<sup>62</sup> *Id.*

<sup>63</sup> *Id.* at 72056.

<sup>64</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45172, 45197-45198 (proposed July 20, 2004) ("Proposed Release").

<sup>65</sup> *Id.*

<sup>66</sup> Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission ("Staff Report") (Sept. 2003), *available at* <http://www.sec.gov/news/studies/hedgelfunds0903.pdf>, at 73.

<sup>67</sup> Testimony of Patrick J. McCarty, General Counsel of the CFTC, before the U.S. Senate Committee on Banking, Housing and Urban Affairs (July 15, 2004), *available at* [http://banking.senate.gov/\\_files/mccarty.pdf](http://banking.senate.gov/_files/mccarty.pdf), at 1.

involved in the scandal.<sup>68</sup> Moreover, the SEC rejects the argument that it should wait until hedge funds do comprise a disproportionate share of fraudulent activity before it should act.

### 3. Broader Exposure to Hedge Funds

There has been growing hedge fund exposure to smaller investors.<sup>69</sup> This may be at least partially due to the fact that some hedge funds' minimum investment requirements have decreased over time.<sup>70</sup> Outside of the U.S., many hedge fund advisers have already sought to market themselves to smaller investors.<sup>71</sup> Additionally, development of funds to contribute to hedge funds has made hedge funds more readily available to investors.<sup>72</sup> Currently, funds of hedge funds represent 20% of hedge fund capital<sup>73</sup> and are the fastest growing source of capital for hedge funds, increasing 50% since January 1997 (from 16% to 24%).<sup>74</sup>

The dissent argues that the 2003 Staff Hedge Fund Report found no retailization.<sup>75</sup> In addition, the dissent argues, the SEC's concern regarding retail investors' exposure to funds of hedge funds is baseless because the investment minimums for these funds are typically between \$25K and \$1M.<sup>76</sup>

The dissent and commentators suggest three alternatives to universal registration to address the retailization issue: (1) requiring funds

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<sup>68</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72057.

<sup>69</sup> See Staff Report, *supra* note 66, at 81.

<sup>70</sup> *Id.*

<sup>71</sup> See, e.g., Robert Murray, *Vega To Target Smaller Investors*, Alternative Investment News, Aug 20, 2004 (Spanish hedge fund adviser plans to offer a fund of its hedge funds to U.S. investors); see Financial Services Authority, *The CIS Sourcebook-A New Approach, Feedback on CP185 and Made Text*, Mar. 2004, available at <http://www.fsa.gov.uk/pubs/policy/04-07.pdf> (last visited on Oct. 25, 2004); see FSA *May Lift Ban on Hedge Fund Retail Investors*, Reuters, Sept. 29, 2004, available at <http://www.reuters.co.uk> (last visited on Sept. 29, 2004); see Ascarelli and Reilly, *supra* note 52; see Commission des Operations de Bourse (France), *Regulating Alternative Multi-Management Investments*, News Release (Apr. 1 2003) available in File No. S7-30-04; see Matheson Ornsby Prentice, *Establishing a Hedge Fund in Ireland*, 2003, available at <http://www.mop.ie/fileupload/publications> (last visited on Oct. 25, 2004); see Matthew Harrison, *Fund Management in Hong Kong and Singapore*, CSU Research and Policy, Jan. 6, 2003.

<sup>72</sup> Jane Bryant Quinn and Temma Ehrenfeld, *The Street's Latest Lure: Some One Is Going to Mint Money With the New Hedge Funds For Smaller Investors*, NEWSWEEK, May 26, 2003, at 62.

<sup>73</sup> Sanford C. Bernstein & Co., *The Hedge Fund Industry-Products, Services, or Capabilities*, Bernstein Research Call, May 19, 2003, at 18.

<sup>74</sup> See Hennessee Group LLC, *10th Annual Manager Survey*, (2004).

<sup>75</sup> Staff Report, *supra* note 66, at 80.

<sup>76</sup> *Id.* at 69.

of funds targeted to retail investors to register;<sup>77</sup> (2) prohibiting funds from being publicly offered; or (3) placing heightened restrictions on investors.<sup>78</sup> Some commentators also voice concern that mandatory registration may actually accelerate the retailization of hedge funds, because the public may perceive registration with the SEC as a stamp of approval on the hedge funds.<sup>79</sup>

In addition to retailization, the SEC was also concerned that a growing number of pension funds, universities, endowments, foundations, and other charitable organizations have begun to invest or have increased their investments in hedge funds, with the total of institutional investing growing from \$60B in 1998 to \$254B in 2004.<sup>80</sup>

In response to the SEC's concern regarding pension funds, the dissent points out that only one percent of the \$6.4T in U.S. pension funds is currently invested in hedge funds, and that pension fund investments are only eight percent of total hedge fund investments.<sup>81</sup> In fact, the dissent argues that pension funds might actually invest more money in hedge funds if registration is required, as they tend to limit hedge fund investments to those with registered advisers.<sup>82</sup>

#### 4. The Inadequacy of Current Regulation of Hedge Fund Advisers

The current program does not give the SEC the ability to deter or detect fraud by unregistered advisers.<sup>83</sup> The SEC currently relies almost completely on enforcement actions *after* fraud has occurred.<sup>84</sup> In addition, the SEC lacks basic information about advisers and the hedge fund industry, as third-party data often conflicts and is unreliable.<sup>85</sup> The SEC

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<sup>77</sup> Letter from Leon M. Metzger to Jonathan G. Katz, Secretary of the SEC (Sept. 15, 2004), <http://www.sec.gov/rules/proposed/s73004/lmmetzger091504.pdf> ("Letter from Leon M. Metzger").

<sup>78</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72093.

<sup>79</sup> Letter from Madison Capital Management, LLC, *supra* note 23.

<sup>80</sup> See Testimony of Charles J. Gradante, Managing Principal, The Hennessee Group LLC, Address Before the Senate Committee on Banking, Housing and Urban Affairs (July 15, 2004), *available at* [http://banking.senate.gov/\\_files/gradante.pdf](http://banking.senate.gov/_files/gradante.pdf), at 22.

<sup>81</sup> Press Release, Greenwich Associates, Alternative Investments May Disappoint Dabblers (Jan. 21, 2004), *available at* <http://www.greenwich.com>.

<sup>82</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72059.

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> William Fung & David A. Hsieh, *Measuring the Market Impact of Hedge Funds*, 7 J. of Empirical Fin. 1, 3 (2000).

believes that registration of hedge fund advisers is the best way to both deter fraud and collect basic information on the hedge fund industry.<sup>86</sup>

## 5. Role of the SEC

The SEC is the federal agency with the principal responsibility for enforcement and administration of federal securities laws and supervision of the securities markets.<sup>87</sup> The authority provided by federal securities laws permits the SEC to adopt rules and interpret statutes.<sup>88</sup> The federal securities laws call for the SEC to provide for the transparency of markets, prohibit fraud, impose fiduciary obligations,<sup>89</sup> and encourage formation and efficient allocation of capital and participation of investors in capital markets.<sup>90</sup> Conversely, several commentators argue that the SEC should have worked with the President's Working Group on Financial Markets as a collaborative effort as opposed to unilaterally requiring the registration of hedge fund advisers.<sup>91</sup>

### D. *Expected Benefits of Registration*

#### 1. Census Information

Registered advisers must now file Form ADV, the adviser registration form, which provides the data and information needed for the SEC to better understand the operation of hedge fund advisers, plan examinations, better develop regulatory policy, and provide data and information to Congress and other government agencies.<sup>92</sup> Such information includes: (1) the number of hedge funds managed by advisers; (2) the amount of assets in hedge funds; (3) the number of employees and types of other clients the advisers have; (4) the other business activities they conduct; and (5) the identity of persons that control or are affiliated with the firm.<sup>93</sup> Alternatives for the SEC in gathering this information include relying on a coordinated collection of filings and transaction reports

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<sup>86</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72059-60.

<sup>87</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72059.

<sup>88</sup> See *American Trucking Assos., Inc. v. Atchison, T. & S.F.R. Co.*, 387 U.S. 397, 415 (1967).

<sup>89</sup> See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963).

<sup>90</sup> See, e.g., *AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 217 (2nd Cir. 2000).

<sup>91</sup> See, e.g., Letter from U.S. Commodity Futures Trading Commission to Jonathan G. Katz, Secretary of the SEC (Oct. 22, 2004), available at <http://www.sec.gov/rules/proposed/s73004/sbhruska102204.pdf> (Letter from the CFTC).

<sup>92</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72061.

<sup>93</sup> *Id.*

currently made.<sup>94</sup> Although information is not currently in one convenient place, other regulators have offered to share information with the SEC.<sup>95</sup> As another alternative to registration, the SEC could obtain useful information by monitoring transactions of prime brokers.<sup>96</sup> Other commentators have also voiced concerns about duplicative regulation, as some hedge fund advisers are already registered with other regulatory bodies.<sup>97</sup>

The SEC argues that these alternative means of collecting information would be too time-consuming and would still give an incomplete picture of each adviser and the industry as a whole.<sup>98</sup> For example, under any of these alternatives, the SEC still would not know how many hedge funds, advisers, or aggregate hedge fund assets were in existence.<sup>99</sup> Several commentators proposed an annual census or expanded Form D<sup>100</sup> reporting for unregistered advisers, but the SEC refused these approaches because both lack an examination component.<sup>101</sup>

## 2. Keeping Unfit Persons from Using Hedge Funds to Perpetrate Fraud

A component of the new rule denies registration to an adviser who has been convicted of a felony in the last ten years or has had a disciplinary record subjecting them to disqualification.<sup>102</sup> This will be accomplished by

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<sup>94</sup> See, e.g., Letter from Chamber of Commerce, *supra* note 24.

<sup>95</sup> Letter from the CFTC, *supra* note 92; Letter from the National Futures Association to Jonathan G. Katz, Secretary of the SEC (Sept. 14, 2004), *available at* <http://www.sec.gov/rules/proposed/s73004/djroth091404.pdf>.

<sup>96</sup> Alan Greenspan, Chairman, Federal Reserve Board, Written Responses to Questions from Chairman Shelby in Connection with Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs (July 20, 2004).

<sup>97</sup> Letter from the CFTC, *supra* note 92; Letter from the European Commission to Jonathan G. Katz, Secretary of the SEC (Sept. 15, 2004), *available at* <http://www.sec.gov/rules/proposed/s73004/dwright091504.pdf>.

<sup>98</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72061; see also Letter from Long Trail Capital, LLC to Jonathan G. Katz, Secretary of the SEC (Sept. 14, 2004), *available at* <http://www.sec.gov/rules/proposed/s73004/s73004-50.pdf>.

<sup>99</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72061.

<sup>100</sup> Notice of Sale of Securities Pursuant to Regulation D, Section 4(6), and/or Uniform Limited Offering Exemption.

<sup>101</sup> Letter from the American Bar Association, Section of Business Law to Jonathan G. Katz, Secretary of the SEC (Sept. 28, 2004), *available at* <http://www.sec.gov/rules/proposed/s73004/aba092804.pdf>; Letter from the Chamber of Commerce, *supra* note 24.

<sup>102</sup> Item 11 of Part 1 of Form ADV requires applicants for registration as an investment adviser to report felonies and other disciplinary events occurring during the last ten years.

self-reporting on Form ADV and by an SEC staff check against a database of securities violators.<sup>103</sup> The intent of this component is to keep fraudsters, scam artists, and others out of the hedge fund industry, fearing that a lack of scrutiny in the past has likely attracted scam artists to hedge funds.<sup>104</sup>

### 3. Deterrence of Fraud

Registration permits the SEC to conduct examinations to “identify compliance problems at an early stage, identify practices that may be harmful to investors, and provide a deterrent to unlawful conduct.”<sup>105</sup> Examinations are a key part of the investor protection plan and a major reason the SEC is adopting this rule.<sup>106</sup> Examinations are similar to a tax audit in that they are infrequent but are still intended to deter unlawful behavior.<sup>107</sup> Consequences of violations upon examination include fines, disgorgement, industry suspension or bars, and loss of reputation.<sup>108</sup>

Some commentators believe that in the hedge fund context, routine examinations will not be an effective tool for the SEC because of the limited number of examiners, the substantial training costs for the SEC, and the slow examination cycle of the SEC.<sup>109</sup> They assert that any potential deterrent effect of examinations by the SEC will be muted by the SEC’s lack of necessary resources.<sup>110</sup> But the SEC indicates as evidence of the effectiveness of examinations that in five of the eight cases brought against registered advisers in 2005, examination uncovered the fraud.<sup>111</sup> Other commentators agreed that random monitoring does in fact create a deterrent effect.<sup>112</sup>

Opposing commentators also voice concern that examiners will not understand the complex trading strategies and investments of hedge fund

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<sup>103</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72063.

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* at 72061.

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> Letter from W. Hardy Callcott, Bingham McCutchen LLP to Jonathan G. Katz, Secretary of the SEC (Sept. 15, 2004), *available at* <http://www.sec.gov/rules/proposed/s73004/whcallcott091504.pdf>.

<sup>110</sup> Testimony of William H. Donaldson, Chairman, Securities and Exchange Commission, Before the House Subcommittee on Commerce, Justice, State, and the Judiciary, Committee on Appropriations (Mar. 31, 2004).

<sup>111</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72062.

<sup>112</sup> Letter from Alternative Investment Group Service, LP to Jonathan G. Katz, Secretary of the SEC (Aug. 20, 2004), *available at* <http://www.sec.gov/rules/proposed/s73004/s73004-37.pdf>; Letter from Vantis Capital Management, LLC to Robert E. Plaze, Associate Director of the SEC (Aug. 6, 2004), *available at* <http://www.sec.gov/rules/proposed/s73004/s73004-31.pdf>.



advisers, rendering the examiners ineffective and inefficient.<sup>113</sup> Alan Greenspan has echoed this concern, indicating that any possible detection of trading irregularities is likely to only be of historic interest because by the time of detection, hedge funds would have long since moved on to different strategies.<sup>114</sup> The SEC currently oversees a significant number of hedge fund advisers, however, and from this experience the SEC has found that fraud actions brought against hedge fund advisers are similar to those brought against other types of advisers.<sup>115</sup> In both cases, common actions include the misappropriation of assets, portfolio pumping, misrepresentation of portfolio performance, falsification of experience, credentials and past returns, misleading disclosure regarding trading strategies, and improper valuation of assets.<sup>116</sup>

The dissent further claims that the mutual fund market timing scandal is evidence that registration and threat of examination are not an effective deterrent to fraud because that examination did not uncover the illegal conduct despite that all mutual fund advisers involved were registered and that twenty of the seventy hedge fund advisers involved were registered.<sup>117</sup> The SEC argues that just because registration and examination do not prevent all fraud does not mean that we should not have them at all.<sup>118</sup>

Several commentators argue that the hedge fund industry is already a highly legitimate and professional industry with financially sophisticated investors who can evaluate matters such as management fees, leverage, and investment risk on their own behalf.<sup>119</sup> Hedge fund investors can and do perform due diligence (or hire someone to do it for them), review audit reports or third-party internal control reports, and enlist help if they suspect fraud or malfeasance.<sup>120</sup> Moreover, hedge fund investors have been able, through private ordering, to negotiate adequate protections for themselves (protections at least as effective as SEC oversight), and market pressures are

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<sup>113</sup> See, e.g., Letter from Schulte Roth & Zabel LLP to Jonathan G. Katz, Secretary of the SEC (Sept. 15, 2004), *available at* <http://www.sec.gov/rules/proposed/s73004/schulte091504.pdf>.

<sup>114</sup> Alan Greenspan, Chairman, Federal Reserve Board, Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs (July 20, 2004).

<sup>115</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72062.

<sup>116</sup> *Id.*

<sup>117</sup> See, e.g., Letter from Millrace Asset Group to Jonathan G. Katz, Secretary of the SEC (Sept. 15, 2004), *available at* <http://www.sec.gov/rules/proposed/s73004/djhammond091504.pdf>.

<sup>118</sup> *Id.*

<sup>119</sup> S. Rep. No. 104-293, at 10 (1996).

<sup>120</sup> Letter from W. Hardy Callcott, *supra* note 110.

enhancing investor protection as reflected in the increasing percentage of hedge funds that are audited or rely on third-party administration.<sup>121</sup>

In response to this argument, the SEC asserts that although the hedge fund industry has historically been limited to highly sophisticated investors, the trend towards the retailization of hedge funds is inevitable and has already begun in the United States.<sup>122</sup> As less-sophisticated investors increasingly seek access to hedge fund investments, the SEC has an obligation to protect such investors from the inherent risks and fee structures of hedge funds.<sup>123</sup>

#### 4. Adoption of Compliance Controls

The 2003 Staff Hedge Fund Report indicated that some hedge fund managers have very informal controls, which is a concern to the SEC, to hedge fund investors, and to institutional investors.<sup>124</sup> The SEC feels that it is in the best position to determine what constitutes a satisfactory compliance infrastructure.<sup>125</sup> This aspect of the new rule requires advisers to designate a Chief Compliance Officer (“CCO”) and to adopt policies and procedures (compliance infrastructure) sufficient to prevent violation of the Advisers Act.

Opposing commentators are concerned about the cost of the compliance infrastructure and of submitting to compliance examinations, and they believe that the required registration will have a detrimental effect on the industry and may lead to the closing of many small advisers.<sup>126</sup> The SEC argues that the costs of compliance will be reasonable, especially in light of the substantial cash flow provided to hedge fund advisers by their typical fee structure (two percent management fee and twenty percent performance fee).<sup>127</sup> Moreover, many registered investment advisers manage comparable amount of assets, charge much lower fees, and bear the same compliance costs.

The SEC estimates that it will cost an average of \$20,000 in professional fees and \$25,000 in internal costs per year to develop a

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<sup>121</sup> Letter from the Chamber of Commerce, *supra* note 24; Letter from Price Meadows Incorporated to Jonathan G. Katz, Secretary of the S.E.C. (Sept. 15, 2004), *available at* <http://www.sec.gov/rules/proposed/s73004/price091504.pdf>.

<sup>122</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72057.

<sup>123</sup> *Id.* at 72059.

<sup>124</sup> Staff Report, *supra* note 66, at 110.

<sup>125</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72063.

<sup>126</sup> See Letter from Madison Capital, *supra* note 23, at 3-5; Letter from Seward & Kissel LLP to Jonathan G. Katz, Secretary of the SEC (Sept. 15, 2004), *available at* <http://www.sec.gov/rules/proposed/s73004/poglinco091504.pdf>.

<sup>127</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72064.

compliance infrastructure for hedge fund advisers based on its discussions with industry experts and attorneys who counsel advisers.<sup>128</sup> Not surprisingly, commentators estimate that the costs of compliance will be considerably higher.<sup>129</sup>

#### E. *Costs of Registration*

The SEC asserts that fears of registration inhibiting fund advisers from engaging in complex or innovative strategies for fear of being second-guessed by the SEC examination staff are refuted by the experience of registered hedge fund advisers.<sup>130</sup> For example, “[r]egistration [does] not require hedge fund advisers to reveal their trading strategies, disclose their portfolio holdings, [] interfere in any way with their ability to leverage their portfolios, ... [or] restrict the ability of hedge funds to provide liquidity to the market.”<sup>131</sup> A recent study found that there was no difference between the performances of funds managed by registered advisers versus those managed by unregistered advisers,<sup>132</sup> and that five of the ten largest hedge fund advisers are registered.<sup>133</sup> The fact that over 8,500 advisory firms (managing over \$23T in assets) are registered under the Advisers Act is evidence that registration is not a competitive disadvantage.

Nevertheless, the dissent maintains that this rule will divert already stretched resources from over 90 million mutual fund investors to an estimated 200,000 hedge fund investors.<sup>134</sup> Other commentators voice concern that the SEC’s cost-benefit analysis is not realistic and that costs of compliance will inevitably be considerably higher than those predicted by the SEC.<sup>135</sup>

#### F. *Alternatives to Mandatory Registration*

It is likely that the courts will find that the SEC has the authority to make the new rule requiring the registration of hedge funds. In the absence of an airtight argument that the new rule is contrary to the clear intent of Congress, the courts are unlikely to interfere with the regulatory body

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<sup>128</sup> Proposed Release, *supra* note 64, at 45190.

<sup>129</sup> See, e.g., Letter from Madison Capital, *supra* note 23, at 3-5.

<sup>130</sup> See, e.g., Letter from Investment Company Institute to Jonathan G. Katz, Secretary of the SEC (Sept. 15, 2004), available at <http://www.sec.gov/rules/proposed/s73004/erkrentzman091504.pdf>.

<sup>131</sup> *Id.*

<sup>132</sup> *Bids & Offers*, WALL ST. J., July 23, 2004, at C4.

<sup>133</sup> See *The Hedge Fund 100*, INSTITUTIONAL INVESTOR, May 14, 2004.

<sup>134</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72094.

<sup>135</sup> See, e.g., Letter from the Managed Funds Association, *supra* note 23, at 21.

whose sole purpose is the enforcement and administration of federal securities laws and supervision of the securities markets.

But the wisdom and effectiveness of the new rule is questionable. If the SEC was primarily concerned about gaining information about the hedge fund industry, other less intrusive means, such as an annual census, could be used to gain such information without requiring registration. An annual census would also allow the SEC to accomplish another of its objectives: keeping unfit persons (those with a felony in the past ten years) from managing hedge funds. In the comments received by the SEC in its original investigation, few commentators raised any complaint regarding either of these objectives of the SEC. Additionally, if only requiring an annual census of hedge funds, the SEC would completely avoid the need to alter the well-established interpretation of § 203(b)(3) of the Investment Advisers Act.

Aside from merely collecting information on the hedge fund industry, the SEC made it clear that it believed the examination component to be an integral part of the new rule,<sup>136</sup> and it is primarily this component that is so staunchly opposed by many in the hedge fund industry. Particularly, with the requirement of certain compliance controls and the designation of a compliance officer, the SEC seems to be micro-managing highly capable and advanced investment advisers in an industry which is dominated by highly sophisticated investors.

In response to this argument, the SEC argues that the threat of retailization has changed the landscape of the industry<sup>137</sup> and that SEC regulation is necessary to protect less-sophisticated investors who may invest in hedge funds or funds of hedge funds.<sup>138</sup> Yet to the extent that retailization of hedge funds is a concern to the SEC, an alternative to registration is to bolster the minimum investment restrictions on those who are permitted to invest in hedge funds. Many hedge fund participants at the SEC Roundtable discussions expressed no desire or intent to offer their investments to smaller, or retail, investors.<sup>139</sup> Other experts also argue that the only way to protect smaller investors from the risks of hedge funds is to prevent the retailization of hedge funds altogether.<sup>140</sup> Maintaining, if not bolstering, the minimum investment requirements could accomplish this for hedge fund investors.

It is uncontested that hedge funds have a unique and valuable role in the national economy and that the lack of regulatory restrictions on hedge funds to date has played a role in encouraging the formation of large asset

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<sup>136</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72061.

<sup>137</sup> *Id.* at 72057.

<sup>138</sup> *Id.* at 72058.

<sup>139</sup> *Id.* at 72057.

<sup>140</sup> See David F. Swensen, *Invest at Your Own Risk*, N.Y. TIMES, Oct. 19, 2005, at A21.

pools which provide valuable liquidity to the national economy.<sup>141</sup> Thus, a better alternative than registration would be for the SEC to: (1) gather basic information on the hedge fund industry with an annual census and (2) maintain and bolster the minimum investment requirements of hedge funds to prevent the retailization of hedge funds in the United States. This approach would permit the SEC to collect the information it seeks regarding hedge fund advisers, protect smaller, less-sophisticated investors from the risks and fee structures of hedge funds, and encourage valuable investment in hedge funds in the United States by allowing the industry to continue without further regulation by the SEC. Such a strategy would also alleviate the need for an inconsistent interpretation of the Investment Advisers Act and avoid the inherent inefficiencies of attempting to micro-manage an extremely sophisticated industry.

Unfortunately, the course of the SEC appears to be set. Assuming the courts permit the new rule, Christopher Cox, the SEC's new chairman, said recently that he does not intend to overturn the policy initiatives of his predecessor, William Donaldson, including the new hedge fund rule.<sup>142</sup>

As the new rule goes into effect, it is likely that the new era of the hedge fund industry will begin with more of a mild groan than a raucous uproar. After all, the mutual fund industry has survived, and arguably prospered, over a stretch of many years while registered with the SEC. Undoubtedly, many previously unregistered hedge fund advisers will be frustrated over the additional time, expense, and energy devoted to the registration process, compliance guidelines, and SEC examinations. But perhaps more importantly, mandatory registration of hedge funds is likely to have a net effect of encouraging investors to organize or invest in hedge funds overseas rather than the United States to avoid SEC regulation.

Considering that many experts believe that SEC regulation, for a number of reasons, is unlikely to be highly effective in preventing fraud in the hedge fund industry, it seems likely that SEC registration will do more harm than good. The empirical results may be difficult to quantify, and it may be years before the final verdict is in as to the net benefit or detriment of the new rule. But in the meantime, United States hedge fund advisers must prepare for a new regime—that of registration with the SEC.

Yet despite the recent debate surrounding the new registration rule of the SEC, hedge fund advisers are not sitting around waiting for SEC registration. Hedge fund advisers are continually inventing new investment strategies to increase fund performance. An example of a new and controversial strategy being utilized by hedge fund advisers is an “activist event driven” strategy, which is analyzed in detail in the following section.

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<sup>141</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, at 72059.

<sup>142</sup> Labaton, *supra* note 1.

IV. THE IMPACT OF HEDGE FUND ACTIVISM ON CORPORATE  
DECISION-MAKINGA. *Introduction*

This section analyzes the legal path taken by hedge fund managers to bring about corporate changes, such as stock repurchases, increased distributions, and asset spin-offs.<sup>143</sup> The path supports a contention that, as a result of the circumvention of the shareholders' rights plan (commonly referred to as a "poison pill"),<sup>144</sup> there exists no substantial barrier preventing activist hedge fund managers to successfully influence corporate change. Moreover, when influences are ineffective to get the board to comply, a proxy contest is the tool to bring changes in both management and corporate policy.<sup>145</sup>

Hedge fund advisers have used a variety of investment techniques to provide absolute returns to an investor, regardless of the stock or bond market environment.<sup>146</sup> One such technique is the aptly titled "event driven" category of hedge fund investing.<sup>147</sup> These funds attempt to profit through investing in securities of companies where significant corporate changes are affecting the value of the corporation, such as bankruptcies, reorganizations, and mergers.<sup>148</sup>

This technique of investing is not unique in theory, but the manner in which certain event driven hedge fund managers put theory into practice differs significantly from investors of the past.<sup>149</sup> For clarity, this Note will refer to this style of hedge fund activity as activist event driven ("AED") hedge funds.<sup>150</sup> The managers of these hedge funds are the catalysts for the corporate change from which they hope to profit. Similar to investment

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<sup>143</sup> See Steven Gray, *Activist Investor to Offer New Plan for McDonald's*, WALL ST. J., Jan. 18, 2006, at B11; see also *McDonald's Shares Rise; hedge fund investment rumored*, AFX INTERNATIONAL FOCUS, Sept. 16, 2005; see also Barnet D. Wolf, *Wendy's to Split with Tim Hortons; Initial Sale of Small Stake to Be Followed by Chain's Spinoff within Two Years*, THE COLUMBUS DISPATCH, July 30, 2005, at 01D.

<sup>144</sup> Brian J. McTear, Comment, *Has the Evolution of the Poison Pill Come to an End? – Carmody v. Toll Brothers, Inc.; Mentor Graphics, Inc. v. Quickturn Design Systems, Inc.*, 24 DEL. J. CORP. L. 881, 882 (1999).

<sup>145</sup> E.g., Erica Laudano, Note and Comment, *One Man's Junk Mail Is Another Man's Treasure: Proxy Contests and Corporate Governance*, 3 CONN. PUB. INT. L.J. 430, 431 (2004).

<sup>146</sup> See generally Adel A. Al-Sharkas, *The Return in Hedge-Fund Strategies*, INT. J. OF BUS., 10(3) (2005), at 222, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=778404](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=778404).

<sup>147</sup> E.g., Working Group, *supra* note 7, at 3.

<sup>148</sup> *Id.*

<sup>149</sup> See Riva D. Atlas, *Some Funds Taking Role Far Beyond Just Investor*, N.Y. TIMES, Aug. 16, 2005, at C1.

<sup>150</sup> *Id.*

targeting leveraged buy-out (“LBO”) firms used in the 1980s, most AED hedge fund managers today are looking to invest in undervalued<sup>151</sup> or mismanaged corporations, create change, and thus bring value to their investment.<sup>152</sup> As long as the SEC does not attempt to regulate this conduct, the highly liquid hedge funds will have a substantial impact upon the management of American corporations. To that end, future hedge fund managers will not be prevented from such conduct unless prevented by means of a negative market reaction or by SEC involvement.

As mentioned above, AED hedge funds have begun to employ a more aggressive investment strategy, where successful investment is reliant upon the fund manager’s activism as a shareholder of the corporation.<sup>153</sup> Ideally, the fund manager will propose corporate conduct that will make the investment profitable and create value for the company. In other words, both the corporate policy and the long-term strategy are changed when the corporate board adopts the hedge fund manager’s plan to maximize shareholder value.<sup>154</sup> This technique has not proven to exist without challenge.<sup>155</sup> In many situations, the board has been reluctant to accept the fund manager’s advice on how to best manage the corporation to maximize shareholder value.<sup>156</sup> When a board disagrees with a fund manager’s views the fund manager may engage in a proxy contest.<sup>157</sup> If successful, this move replaces incumbent directors with people who share the fund manager’s view on how to restructure the company.<sup>158</sup>

In the past two decades there have emerged several popular methods of applying pressure to incumbent management of a corporation.

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<sup>151</sup> “Undervalued” means there is a positive difference between the intrinsic value of the firm and the market value of the total stocks.

<sup>152</sup> Memorandum from Wachtell, Lipton, Rosen & Katz, Be Prepared for Attacks by Hedge Funds (Dec. 21, 2005), *available at* <http://www.realcorporatelawyer.com/pdfs/wlrk122205-02.pdf> (The first issue of the document refers to poor performance being the reason for management to be wary of hedge fund activity in the company’s stock).

<sup>153</sup> Atlas, *supra* note 150 (“[A] growing number of hedge fund managers have taken up . . . tactics to wage populist battles against chief executives.”).

<sup>154</sup> *See id.*

<sup>155</sup> *See* Barnett D. Wolf, *Investor Call to Restructure; Wendy’s Won’t Bow to Pressure*, THE COLUMBUS DISPATCH, July 17, 2005, at 01G.

<sup>156</sup> *See generally id.* (setting forth the proposition that Wendy’s disagreed with the Pershing Square Capital Management’s idea of what was best for Wendy’s shareholders).

<sup>157</sup> *See* Blockbuster Inc., Schedule 13D/A (Apr. 28, 2005), *available at* <http://sec.gov/Archives/edgar/data/921669/000092847505000118/blockbuster13d-428.txt>, Exhibit 1 for a description of why the hedge funds wished to participate in a proxy contest.

<sup>158</sup> *Id.*

There was the hostile takeover wave of the 1980s,<sup>159</sup> followed by the increased use of proxy contests of the 1990s.<sup>160</sup> AED hedge funds are the newest vehicles for aggressive investing through management pressure.<sup>161</sup> As such, they are faced with the same obstacles that the corporate raiders and shareholder activists faced in the 1980s and 1990s.

Corporate “raiders” of the ‘80s (a.k.a. LBOs) were financial firms that used significant debt (leverage) to acquire a target company.<sup>162</sup> After the acquisition was complete, the raider would recapitalize or reorganize the target firm’s capital structure for two reasons: first, to pay off the debt used for the acquisition and second, to turn the company into a more profitable business.<sup>163</sup> Due to changes made in most state corporate codes, hostile LBO firms are no longer able to employ this investment style.<sup>164</sup> The hostile LBO firms targeted corporations in much the same way as AED hedge funds, in that they sought out firms which they thought could be improved through structural or policy changes.<sup>165</sup> LBO firms from the past, however, were distinct from AED hedge funds today in one major way. LBO firms operated through the acquisition of the entire target corporation.<sup>166</sup>

Many corporations adopted poison pill plans, and many state legislatures adopted anti-takeover statutes to decrease a corporation’s susceptibility to confrontation from an unwanted acquirer.<sup>167</sup> The two devices mentioned above neither deter nor affect an investor or a group of investors who never cross a certain threshold of ownership in the corporation.<sup>168</sup> The mechanics of poison pill plans and anti-takeover statutes are not effective when there is no acquiring entity. For example,

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<sup>159</sup> See Guhan Subramanian, *A New Takeover Defense Mechanism: Using an Equal Treatment Agreement as an Alternative to the Poison Pill*, 23 DEL. J. CORP. L. 375, 376 (1998).

<sup>160</sup> See Laudano, *supra* note 146.

<sup>161</sup> See e.g., Memorandum from Wachtell, Lipton, Rosen & Katz, *supra* note 153.

<sup>162</sup> See DALE A. OESTERLE, *THE LAW OF MERGERS AND ACQUISITIONS* 621 (1991).

<sup>163</sup> See *id.* at 277.

<sup>164</sup> See *id.* at 602 n.110. (citing DEL. CODE ANN. tit. 8, § 203 (1991) (prohibiting any merger or sale of assets within three to five years after the bidder acquires a triggering percentage of target’s shares—a “business combination” statute)).

<sup>165</sup> See OESTERLE, *supra* note 163, at 621.

<sup>166</sup> *Id.* at 273.

<sup>167</sup> See Laudano, *supra* note 146, at 430 (“In the 1990s, these negative attitudes towards proxy contests changed. With the widespread adoption of poison pills, the proliferation of state anti-takeover laws, and the relative unavailability of financing for financially motivated hostile takeovers, proxy contests became an important tool by which potential acquirers could facilitate hostile takeovers”).

<sup>168</sup> Shareholder’s Rights Plans require a certain percentage of a class’s outstanding stock to be beneficially owned by a “person” before the Rights Plan vests. The Delaware Business Combination Statute does not allow the acquirer of at least eighty-five percent of a corporation’s voting stock to combine the corporation with another entity for a period of three years. See DEL. CODE ANN. tit. 8, § 203(a)(2) (2005).



*Business Combination Statutes* (adopted during the 1980s) only prevent takeovers if the acquiring entity wishes to merge or divest part of the target company once acquired.<sup>169</sup> Since AED hedge funds have no intention of acquiring legal or effective control of the company, the funds' conduct is outside the scope of the state of incorporation's business combination statutes. Nevertheless, poison pills still remain a legitimate obstacle to corporate takeovers.<sup>170</sup>

The next section outlines hedge fund investor activism, while Section C discusses methods of avoiding the poison pill and using a proxy contest to bring about change. Section D provides conclusions and proposals regarding future regulations affecting hedge funds.

### B. *Hedge Fund Activism*

AED hedge fund managers have begun to employ a novel technique to exploit profitable transactions. These funds, through their own analysis, decide to take large positions in a company's equity.<sup>171</sup> In the opinion of the fund manager, the target corporation's stock has been trading lower than its potential intrinsic value.<sup>172</sup> In order for the particular company to become a target of hedge fund activism, the fund manager must both recognize that the stock is undervalued by the market as well as believe that a change can be made to effectively increase the company's market value.<sup>173</sup>

Once a fund manager targets an undervalued company (or a company which contains an undervalued asset) and decides upon the way in which its share value can reflect the company's intrinsic value, the opportunistic fund manager begins to quietly purchase as many of the

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<sup>169</sup> Implied in anti-takeover statutes is the desire of the bidding entity to take over ownership or control of the target corporation. These state statutes require the bidder to obtain approval from the target board prior to attempting a takeover. *See* DEL. CODE ANN. tit. 8, § 203 (2005). Without board approval, the bidder is subject to the effects of the statute.

<sup>170</sup> *See* Jenny Anderson, *When Winning the Battle Leads to Losing the War*, N.Y. TIMES, Oct. 28, 2005, at C7 (describing a hedge fund's raid, proxy contest, and deactivation of BKF Capital Group's poison pill).

<sup>171</sup> *See* Wendy's International Inc., Schedule 13D (Apr. 18, 2005), *available at* [http://sec.gov/Archives/edgar/data/105668/000110465905018018/a05-7319\\_1sc13d.htm](http://sec.gov/Archives/edgar/data/105668/000110465905018018/a05-7319_1sc13d.htm) (last visited Feb. 13, 2006).

<sup>172</sup> *See generally* Atlas, *supra* note 150 (describing hedge fund manager's effort to spearhead the "shareholder activism" movement against underperforming management); *see also* BODIE ET AL., *supra* note 7, at 609 ("[i]ntrinsic value" of a "share of stock is defined as the present value of all cash payments to the investor in the stock, including dividends as well as the proceeds from the ultimate sale of the stock, discounted at the appropriate risk-adjusted interest rate").

<sup>173</sup> *See e.g.*, Memorandum from Wachtell, Lipton, Rosen & Katz, *supra* note 153.

firm's stocks as he can for the lowest possible cost.<sup>174</sup> The reason the fund manager wishes to purchase shares quietly is to avoid a price impact from large bulk purchases.<sup>175</sup> The fund manager will continue to quietly purchase the target firm's stocks until the fund owns five percent of a specific class of the firm's stocks. The fund can then purchase as many securities as it desires within the next ten days before it is required by the Securities Exchange Act of 1934 to file a Schedule 13D with the Securities and Exchange Commission.<sup>176</sup>

### 1. Schedule 13D

The rule 13(d)(1) of the Securities Exchange Act of 1934 requires,

[a]ny person . . . acquiring directly or indirectly the beneficial ownership of any equity security of a class . . . of more than 5 per centum of the class shall, within ten days after such acquisition . . . file with the Commission [SEC], a statement containing such of the following information . . . as the Commission may by rules and regulations, prescribe as necessary or appropriate . . .<sup>177</sup>

With that authority, the SEC promulgated the required filing of forms Schedule 13D or 13G that disclose the five percent investor's holdings in the issuer and purpose for the purchases.<sup>178</sup> This rule gives a person who would normally file a Schedule 13D the option of filing form 13G if "[s]uch person has acquired such securities in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect."<sup>179</sup> Because the intentions of the fund managers are to influence the issuer, the AED fund manager files a Schedule 13D instead of 13G.<sup>180</sup> Notice that the hedge fund manager does

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<sup>174</sup> The term "undervalued" is meant to encompass corporations which can increase their value through changing certain corporate policies to unlock optimal value per share.

<sup>175</sup> See Subramanian, *supra* note 160.

<sup>176</sup> 17 C.F.R. § 240.13d-1(a) (2006).

<sup>177</sup> 15 U.S.C. § 78m(d)(1) (2006).

<sup>178</sup> 17 C.F.R. § 240.13d-1(a)-(b) (2006).

<sup>179</sup> 17 C.F.R. § 240.13d-1(b)(1)(i) (2006).

<sup>180</sup> See Wendy's International Inc., Schedule 13D (Apr. 18, 2005), *available at* [http://sec.gov/Archives/edgar/data/105668/000110465905018018/a05-7319\\_1sc13d.htm](http://sec.gov/Archives/edgar/data/105668/000110465905018018/a05-7319_1sc13d.htm); Wendy's International Inc., Schedule 13D (Dec. 6, 2005), *available at* <http://sec.gov/Archives/edgar/data/105668/000095011705004693/a40992.htm>; Star Gas Partners, L.P., Schedule 13D (Apr. 6, 2005), *available at* <http://sec.gov/Archives/edgar/data/1002590/000089914005000357/t2820161.txt>;

not intend to “effect the change” nor “influence the control of the issuer” per se, but rather, the manager intends to persuade the management of the target firm to perform differently so as to maximize share value.<sup>181</sup> It would be remiss, however, to say that the fund manager is not intending on “influencing the control” or “effecting the change” of the firm should the directors of the target firm not submit to the fund manager’s requests.<sup>182</sup>

Unfortunately, the SEC has not offered a definition of the elastic “influencing control” concept.<sup>183</sup> Furthermore, there are no cases that construe Schedule 13G eligibility, suggesting that shareholders have not tried to use the Schedule 13G when they might want to pursue any effort to nominate and elect directors.<sup>184</sup> The nonuse of the Schedule 13G under these circumstances implies that when a Schedule 13D is filed, as opposed to Schedule 13G, notice is given to the market and the issuer’s management that the investor is positioned to influence the control of the corporation.

Typically, around the time of the fund filing a Schedule 13D, the manager writes a list of demands to the board of directors.<sup>185</sup> The demands are usually included as an exhibit to the Schedule 13D filing.<sup>186</sup> In some instances, the manager attempts to meet with the board for an opportunity to formally present the fund’s proposals of how the company can maximize shareholder value.<sup>187</sup> The fund manager justifies such conduct by playing the role of a concerned stakeholder in an underperforming company.<sup>188</sup>

Blockbuster Inc., Schedule 13D (Apr. 6, 2005), *available at* [http://sec.gov/Archives/edgar/data/919085/000116923205002092/d63342\\_sc13d.txt](http://sec.gov/Archives/edgar/data/919085/000116923205002092/d63342_sc13d.txt); OfficeMax Incorporated, Schedule 13D (Feb. 23, 2005), *available at* [http://sec.gov/Archives/edgar/data/12978/000110465905008403/a05-4227\\_1sc13d.htm](http://sec.gov/Archives/edgar/data/12978/000110465905008403/a05-4227_1sc13d.htm); OfficeMax Incorporated, Schedule 13D (Jan. 10, 2006), *available at* <http://sec.gov/Archives/edgar/data/12978/000091412106000046/kc723026-13da7.txt>.

<sup>181</sup> See Wendy’s International Inc., Schedule 13D, at Item 4 (Dec. 6, 2005), *available at* <http://sec.gov/Archives/edgar/data/105668/000095011705004693/a40992.htm>.

<sup>182</sup> See Wendy’s International Inc., Schedule 13D, at Exhibit 2, Provision 2 of the Recitals (Dec. 6, 2005), *available at* <http://sec.gov/Archives/edgar/data/105668/000095011705004693/ex2.htm>.

<sup>183</sup> See Bernard S. Black, Article, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 545 (1990).

<sup>184</sup> *Id.*

<sup>185</sup> See OfficeMax Incorporated, Fund manager’s list of requests, at Exhibit 2 (Oct. 26, 2005), *available at* <http://www.sec.gov/Archives/edgar/data/12978/000089534505001050/jb13daex2.txt>; Wendy’s International Inc., Schedule 13D, at Exhibit 3 (Dec. 12, 2005), *available at* <http://www.sec.gov/Archives/Edgar/data/105668/000095011705004693/ex3.htm>.

<sup>186</sup> *Id.*

<sup>187</sup> *Id.*

<sup>188</sup> See Wendy’s International Inc., Schedule 13D, at Item 4 (Apr. 18, 2005), *available at* [http://www.sec.gov/Archives/edgar/data/105668/000110465905018018/a05-7319\\_1sc13d.htm](http://www.sec.gov/Archives/edgar/data/105668/000110465905018018/a05-7319_1sc13d.htm) (suggesting that no action will be taken unless the shareholder thinks the company is underperforming).

## 2. Misconceptions of the “Group” Classification

There have been many publications about AED hedge funds working in undisclosed groups dubbed “wolf packs” in order to influence corporate management.<sup>189</sup> Current speculation concerning activist hedge funds purports that one fund is used to lead the effort while other funds support the effort without disclosing their involvement.<sup>190</sup> There is no empirical data supporting this proposition. SEC Schedule 13D filings suggest this is true to the degree that some activist hedge funds invest together,<sup>191</sup> but the implied proposition that more funds were working together than were disclosed<sup>192</sup> is unlikely accurate. For the following reasons, it makes little sense that AED hedge funds would operate in a collusive syndicate without disclosure in order to influence corporate changes: (1) if hedge funds were working together they would be required to disclose this fact within the 13D filing once the sum of the funds’ beneficial ownership has crossed the five percent marker in order to comply with SEC regulations;<sup>193</sup> (2) the filing fund will have enough support in proxy contest without having a collusive syndicate of hedge funds as long as the filing fund’s desired structural changes will increase the value of the corporation;<sup>194</sup> (3) the filing fund stands to make greater profits without other hedge funds acting as competing bidders for a company’s stock;<sup>195</sup> and (4) it is unnecessary for the fund to have commitment from other funds prior to the proposition of their corporate restructuring plan.<sup>196</sup>

The Securities Exchange Act refers to any group of “two or more persons act[ing] as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an

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<sup>189</sup> See Phyllis Plitch, *Lawyers See No Poison Pill To Feed Hedge Fund ‘Wolf Packs’*, DOW JONES CORPORATE GOVERNANCE, at 4, Dec. 21, 2005.

<sup>190</sup> See Phyllis Plitch, *Hedge Funds Find Cure For Poison Pill: Teamwork*, WALL ST. J., Dec. 20, 2005, at C3, (citing Martin Lipton, who is credited for inventing the poison pill).

<sup>191</sup> E.g., Schedule 13D, *supra* note 181, at cover page 2a.

<sup>192</sup> See Phyllis Plitch, *supra* note 190.

<sup>193</sup> Securities and Exchange Act of 1934 §13(d)(1)(A), 15 U.S.C. § 78m(d)(1)(A) (2004).

<sup>194</sup> Investors in the subject corporation have an interest in increasing the economic value of the corporation. Therefore, shareholders are more likely to vote in favor of management who will enforce policy most likely to increase the value of the corporation.

<sup>195</sup> Price impact is a popularly recognized affect of large stock purchases. The occurrence of a large stock purchase can result in a temporarily inflated asking price for the stock. The same result will occur when there is great demand for a specific stock. Asking price will increase while demand increases until the market for the stock reaches equilibrium.

<sup>196</sup> This assumes no fund-of-funds are limited partners or member investors in the filing fund.

issuer . . . shall be deemed a ‘person’ for the purposes of this subsection.”<sup>197</sup> “The Commission defines ‘group’ to include ‘two or more persons [who] agree to act together for the purpose of acquiring, holding, *voting*, or disposing of equity securities.’ . . . [A] ‘group’ can be formed informally, without written documentation.”<sup>198</sup> As the Second Circuit has stated, “the touchstone of a group within the meaning of Section 13(d) is that the members combined in furtherance of a common objective.”<sup>199</sup> Although the Second Circuit did not discuss whether a group could be formed without any communication between the investors, the facts of the case required analysis on whether the agreement had to be express or implied between the investors.<sup>200</sup> For purposes of determining a “group of investors” for a Schedule 13D, it seems unlikely any investors that have not been in communication with each other could be construed as being “members of a group.”<sup>201</sup> Otherwise, “furtherance of a common objective” would be broad enough to require all investors agreeing on any change in corporate policy to file a Schedule 13D regardless of whether their purpose for investing was to effect or influence the issuer. That said, should the activist hedge funds communicate with one another to establish a strategy about a specific company and not disclose that they were part of a group at the time of filing a Schedule 13D form, the filing fund would be subject to § 15(c)(4) or § 21(a) proceedings at the discretion of the SEC.<sup>202</sup>

*C. The Impotence of the Shareholders’ Rights Plan and Why Proxy Contests Have Been Successful*

In many of the cases that have occurred over the previous year, the boards have not immediately agreed with the fund manager’s proposals.<sup>203</sup> In extreme circumstances, a member of the board may comment publicly through a press release or interview as to why the board disagrees with the proposal.<sup>204</sup> Interference with a long-term strategy,<sup>205</sup> unwanted effects on corporate cash flow, and disagreement concerning forecasts are some

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<sup>197</sup> Securities Exchange Act of 1934 § 13(d)(3), 15 U.S.C. § 78m(d)(3) (2004).

<sup>198</sup> Black, *supra* note 184, at 543.

<sup>199</sup> Wellman v. Dickinson, 682 F.2d. 355, 363 (2nd Cir. 1982).

<sup>200</sup> *See id.*

<sup>201</sup> SEC Schedule 13D Form Cover Page, *available at* <http://www.sec.gov/divisions/corpfin/forms/13d.htm>.

<sup>202</sup> *See* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 202-03 (Foundation Press 2005). (Only after the “person” or issuer has been found to violate § 15(c)(4) can the SEC request a court order compelling obedience).

<sup>203</sup> For an example *see* Wolf, *supra* note 156.

<sup>204</sup> *See* Wolf, *supra* note 156; *see also* Blockbuster’s response to Carl Ichan’s demands on the board as an example of public disagreement by the board, *available at* [http://www.hackingnetflix.com/2005/04/blockbuster\\_pre.html](http://www.hackingnetflix.com/2005/04/blockbuster_pre.html).

<sup>205</sup> *Id.*

reasons why a board of directors would choose not to implement a hedge fund manager's proposal.

Once the fund manager's proposal has been denied, the fund manager has two options: sell the fund's stake in the company or influence corporate governance. Because the fund manager still believes that the company is undervalued, the fund manager is unwilling to sell the fund's stake in the company without having realized profit on the investment. Therefore, the AED hedge fund manager will choose to influence corporate governance of the company.

The major way a shareholder can influence corporate governance is through gaining a presence on the board of directors.<sup>206</sup> This is best done through a successful proxy contest.<sup>207</sup> Thus, the proxy contest has become the tool used by AED hedge funds to impose their views upon unwilling boards.<sup>208</sup>

### 1. Proxy Contest

Owning a share of corporate common stock conveys three rights on the owner: (1) the right to convey a return on investment; (2) the right to receive a proportionate interest as a residual claimant of the corporation; and (3) the right to vote.<sup>209</sup> Shareholders that cannot attend the annual meeting can proxy their vote through a proxy-holder who represents the shareholder and votes in the manner granted by the shareholder's preference.<sup>210</sup> The Federal Securities Exchange Act of 1934 § 14(a) allowed the SEC to make "rules governing the solicitation of proxies 'as necessary or appropriate in the public interest or for the protection of investors.'"<sup>211</sup> The rules promulgated by the SEC require persons soliciting proxy to vote for an alternate management slate to furnish shareholders with a proxy statement prior to or concurrent to solicitation (14a-3), and the statement must have been pre-filed with the SEC (14a-6).<sup>212</sup> The SEC rules also allow a shareholder in opposition to incumbent directors the right to

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<sup>206</sup> See Laudano, *supra* note 146, at 444.

<sup>207</sup> *Id.*

<sup>208</sup> See Blockbuster Inc., Schedule 13D/A, at exhibit 1, (Apr. 28, 2005), available at <http://sec.gov/Archives/edgar/data/921669/000092847505000118/blockbuster13d-428.txt>.

<sup>209</sup> Laudano, *supra* note 145, at 432. Due to Federal Securities Law and State Fiduciary Duty Law directors are substantially limited on restraining shareholder voting.

<sup>210</sup> See Tara L. C. Van Ho, Comment and Case Note, *Reconstructing the Marriage of Ownership and Control: Is the SEC Missing an Important Step in its Hesitancy to Adopt Proposed Rule 14A-11?*, 73 U. CIN. L. REV. 1211, 1212 (2005).

<sup>211</sup> Laudano, *supra* note 146, at 433 (describing the rule making power of the SEC as enacted in the 1934 Act). 15 U.S.C. § 78n(a).

<sup>212</sup> *Id.*

obtain a list of shareholders from management or to have management mail the dissident's proxy materials to the shareholders, either of which to be done at the expense of the dissident shareholder.<sup>213</sup> The final SEC requirement relevant to proxy contests of hedge funds is the obligation to promote candid truthful disclosure in the proxy statement (14a-9).<sup>214</sup>

## 2. Analysis: Why Proxy Contests Have Been and Will Continue to be Successful

Even though the hedge fund manager is confident the corporation could realize greater value for its stockholders, this does not mean that compliance with the fund manager's suggestions is in the best interest of the corporation. It is important to understand why hedge fund managers have been successful in proxy contests.<sup>215</sup>

Many hedge fund strategies, by their nature, rely on short-term investments.<sup>216</sup> In the past, proxy contests have resulted in increased gain to shareholders of the firm.<sup>217</sup> Thus, speculative short-term investors, such as hedge funds reasonably view proxy contests as good short-term investments.

Therefore, when a fund manager files a Schedule 13D with the SEC, making his requests and intentions public, the rest of the market is on notice that there is likely a proxy contest in the near future. Speculative investors, such as other hedge funds, react to this news by buying shares of the subject corporation. When the activist hedge fund makes the public aware of its purchase and intention to have changes made, however, the investment becomes too risky for many investors.

Uncertainty of a corporation's future returns is a common measure of risk.<sup>218</sup> Whenever a corporation's management is in question, there is uncertainty surrounding the firm's future performance.<sup>219</sup> As a result of this

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<sup>213</sup> *Id.*

<sup>214</sup> *Id.*

<sup>215</sup> Examples of successful hedge fund proxy contests have occurred at TimeWarner, BKF Capital, and Blockbuster Video.

<sup>216</sup> See generally Adel A. Al-Sharkas, *The Return in Hedge Fund Strategies*, INT. J. OF BUS., 10(3), 2005, at 221, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=778404](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=778404). All references to arbitrage opportunities support the assertion that many hedge fund investing strategies are focused on short term as opposed to long term investments.

<sup>217</sup> See generally Laudano *supra* note 146 at 436 footnotes 21, 22. (citing Peter Dodd & Jerold Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 J. FIN. ECON. 401 (1983)); Harry DeAngelo & Linda DeAngelo, *Proxy Contests and the Governance of Publicly Held Corporations*, 23 J. FIN. ECON. 29 (1989) (this proposition has been well supported by empirical studies).

<sup>218</sup> See BODIE ET AL., *supra* note 7, at 153.

<sup>219</sup> See Laudano, *supra* note 146, at 436-38.

uncertainty, the corporation becomes a more risky investment than some traditional investors wish to bear. But because of hedge funds' investment style, some funds are able to take on the additional risk for the opportunity of greater profits.<sup>220</sup> This phenomenon is largely a result of traditional investors' unwillingness to increase the idiosyncratic risk contained in their portfolio positions.<sup>221</sup> From the other vantage point, many hedge fund strategies, such as long/short, take on the idiosyncratic risk that other investors avoid, in hopes of a profit.<sup>222</sup> As a consequence, ownership of the stock of the subject firm is less appealing to many investors but very appealing to some hedge funds. Once a shift in equitable ownership to hedge funds has taken place, the new owners, consisting mainly of short-term investors, have an incentive to support the proposals made by the five percent shareholder. Bear in mind that even though the desires of the new shareholders are probably in line with the changes demanded by the activist hedge fund, they are unlikely members of an official group of investors. For this reason, there should be no violation of the disclosure of five percent beneficial ownership rule of § 13d-1(d), even if the pool of new owners is composed predominantly of hedge funds.<sup>223</sup>

### 3. Shareholders' Rights Plan: The Poison Pill

Shareholders' rights plans were invented in the 1980s as a way to prevent hostile takeovers.<sup>224</sup> The shareholders' rights plan, known as a poison pill,<sup>225</sup> is the most prevalent anti-takeover device of American

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<sup>220</sup> See generally Al-Sharkas, *supra* note 217, at 222. (An increase in uncertainty of a firm's future returns will increase the idiosyncratic risk of the firm and could increase the idiosyncratic risk of the entire portfolio. Thus, a traditional investment approach will require a change in the weights of the portfolio's asset allocation.)

<sup>221</sup> See generally Suleyman Basak, Anna Pavlova & Alex Shapiro, *Optimal Asset Allocation and Risk Shifting in Money Management* (Jan. 2006) available at SSRN id-879294. The study analyzes influential factors of risk shifting behavior by mutual fund managers. The authors state optimal asset allocation of many institutional investor's means shifting positions of the portfolio to take on no idiosyncratic risk (firm specific). *Id.* at 5. (Idiosyncratic risk being firm specific volatility).

<sup>222</sup> See Al-Sharkas, *supra* note 217, at 222. (The reference is to unsystematic risk, which is risk to a very small number of assets. This is essentially identical to idiosyncratic risk, which is also risk from a small number of assets or, more precisely, firm specific risk. Diversification can almost entirely eliminate unsystematic/idiosyncratic risk.)

<sup>223</sup> The "group" classification of 17 C.F.R. § 240.13d-1(J) has never been interpreted broadly enough to consider investors similar, only in investing style, members of a group.

<sup>224</sup> See Shawn C. Lese, Note, *Preventing Control From the Grave: A Proposal for Judicial Treatment of Dead Hand Provisions in Poison Pills*, 96 COLUM. L. REV. 2175, 2175 (1996).

<sup>225</sup> *Id.*



corporations.<sup>226</sup> There are two basic forms of the poison pill, with many possible variations. First, there is the “flip-in” form, most commonly used by target firms through the distribution of a dividend to all common shareholders pro rata.<sup>227</sup> What makes the dividend unique is that it contains a right to purchase shares for a discount once the right vests.<sup>228</sup> Second, there is the “flip-over” form of poison pill, which allows shareholders of the target corporation to purchase a class of shares, usually common shares, in the post acquisition corporation; the purchase price is at a steep discount in the occurrence of a two-step or “squeeze-out” acquisition.<sup>229</sup> The “flip-over” poison pill has no importance in this Note as it only affects post-acquisition firms.

While the stock dividend (of the “flip-in” form of poison pill) gives all shareholders (except the shareholder who crossed the ownership threshold) considerable voting rights, it dilutes the ownership percentage of the aggressor.<sup>230</sup> With the ownership of the aggressor diluted, the voting rights of the hostile acquirer are insignificant.<sup>231</sup> Thus, in a hostile LBO takeover, “the dilution resulting from triggering either [form of poison pill] makes a tender offer a prohibitively expensive method of acquisition.”<sup>232</sup> Activation of the pill was, in part, designed to dilute the voting shares so that the aggressors attempting the LBO will no longer have enough voting power to elect new board members who are supportive of their offer. Yet this is not to say that, if triggered, a poison pill would necessarily prevent an AED hedge fund manager from reaching the fund’s objective. In the past, it was believed that because “a hostile acquisitions cannot be completed without triggering the rights plan, ‘the raider cannot swallow up the company without also ingesting the economic position represented by the value that has to be delivered upon exercise of the rights.’”<sup>233</sup> Today,

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<sup>226</sup> See OESTERLE, *supra* note 163, at 519. The assertion above incorporates the “poison pill preferred,” which is not specifically discussed in this Note, in conjunction with the newer form of the poison pill, the shareholders’ rights plan. The difference between the shareholders’ rights plan form and the poison pill preferred form of poison pill is that the latter uses a preferred share distribution to all shareholders as opposed to the dividend distribution of the former. The preferred shares attach to the common shares and have no voting, dividend, or creditor claimant rights. *Id.* at 85. However, the preferred shares do have a convertible feature which causes each share to “flip-in” to multiple common shares if a large buyer of corporate common stock crosses an ownership threshold without having board approval. *Id.*

<sup>227</sup> Lese, *supra* note 225, at 2180.

<sup>228</sup> *Id.*

<sup>229</sup> See Subramanian, *supra* note 160 at 397.

<sup>230</sup> Lese, *supra* note 225, at 2188.

<sup>231</sup> See McTear, *supra* note 145, at 886.

<sup>232</sup> See Subramanian, *supra* note 160, at 397.

<sup>233</sup> McTear, *supra* note 145, at 886 (quoting ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, TAKEOVER DEFENSES § 5.01[B] 5-7 (5th ed. Supp. 1997)).

however, the poison pill is not effective at protecting the status quo of the corporation against AED hedge funds.

#### 4. Analysis: The Poison Pill's Hidden Weakness

The purpose of a poison pill plan is to protect stockholders from coercive takeover tactics and to “mitigate against market accumulators who through open market and/or private purchases may achieve a position of substantial influence or control without paying to selling or remaining stockholders a fair control premium.”<sup>234</sup> Through the poison pill design, common share certificates carry the unvested dividend right once the plan has been adopted. The unique feature of the dividend becomes exercisable upon the acquisition of beneficial ownership of more than a threshold percentage of the company's outstanding stock.<sup>235</sup> No AED hedge fund has triggered a poison pill of a target corporation's stock over the last two years.

Interestingly, AED hedge funds can approach the purchase of the target corporation's stock differently.<sup>236</sup> Good examples of two different approaches to investing AED fund's can take are the two funds that have recently invested in Wendy's International Inc. (“Wendy's”). Pershing Square Capital Management (“Pershing”) took a long position<sup>237</sup> coupled with call options in Wendy's common stock; alternatively, Trian Fund Management (“Trian”) bought call options while simultaneously selling put options along with taking a long position in Wendy's common stock.<sup>238</sup> This means that Trian had entered a contract to acquire an equal amount of Wendy's stock whether the stock price went above or below the contracted price.<sup>239</sup> Pershing's long position had a combination of common shares and

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<sup>234</sup> See JEFFREY D. BAUMANN, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: STATUTES, RULES AND FORMS 700 (West 2004).

<sup>235</sup> State law in conjunction with the certificate of incorporation determines what the percentage of beneficial ownership of common stock is for the Rights Plan to become exercisable. Del. Gen. Corp. L. §§ 102(a)(4) & 151(a).

<sup>236</sup> This is evidenced by the divergent investment strategies summarized in Schedule 13D Item 5 for both Pershing Capital Management and Trian Fund Management, [http://www.sec.gov/Archives/edgar/data/105668/000110465905018018/a05-7319\\_1sc13d.htm](http://www.sec.gov/Archives/edgar/data/105668/000110465905018018/a05-7319_1sc13d.htm) (last visited Feb. 13, 2006), and <http://sec.gov/Archives/edgar/data/105668/000095011705004693/a40992.htm> (last visited Feb. 13, 2006) respectively.

<sup>237</sup> “Long position” means the investment strategy was to purchase and hold the stock.

<sup>238</sup> Schedules 13D, *supra* note 236.

<sup>239</sup> Since the put contract allowed Trian the right to pay either “the product of the excess between the [named] price above the closing price and the number of shares set forth [in the contract]”, “or acquire the number of shares [agreed upon]... at the price set forth [in the contract].” Trian Fund Management Schedule 13D Item 5, <http://sec.gov/Archives/edgar/data/105668/000095011705004693/a40992.htm>. This allows Trian to not necessarily acquire the shares if the closing price is below the contract price.

call options on common shares.<sup>240</sup> This strategy had minimal downside risk protection.<sup>241</sup> Possession of call options on a large percentage of common shares owned by Pershing mitigated some risk exposure for the fund. If, for some unforeseeable reason, the stock Pershing owned had substantially decreased in value, Pershing could have chosen not to exercise the right to purchase more common stock, resulting only in a loss of the premium paid for the option and a loss on the value of the common stock.<sup>242</sup> On the other hand, Trian's options position allowed Trian the opportunity to profit from its investment if three things occurred: (1) the market price of Wendy's stock is in excess of the contracted price; (2) the excess is greater than the price for the put option; and (3) upon execution of the call, Trian chose to sell the acquired shares to the market. That said, Trian's long position in Wendy's common stock was completely exposed to any downward movement in the stock price.

Under both investing strategies, Pershing and Trian could have accumulated more than a 9.9% stake in Wendy's. Arguably, both funds could have accomplished their proposals, or won a proxy contest had they triggered the poison pill.<sup>243</sup> Even if triggered, the result of the poison pill would be a decrease in the triggering fund's voting rights, and an unknown effect on the value of Wendy's common stock. Regardless of the change in the share price, the fund manager's proposal could still gain popularity among shareholders. With enough support, the triggering fund's insurgent management slate could be voted onto the board. With the new make-up of the board, the fund's proposal would be implemented, ideally resulting in the increase in the value of the stock. Thus, if the market accepts the hedge fund's objective, the poison pill has little to no effect.

Trian's options positions deserve further inspection. Trian would only have to commit to a proxy contest if the share price was less valuable than the put option price. This is because Trian would only have a losing investment if the fund had been forced to buy Wendy's stock for a price in excess of the market price. Before that, Trian had balanced its investment through selling an identical amount in underlying shares through put options as it had purchased in call options.<sup>244</sup> Thus, Trian would only have

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<sup>240</sup> Pershing 13D, *supra* note 236 (look to item 5).

<sup>241</sup> The downside risk the investor faces is the value of the stock decreasing.

<sup>242</sup> See BODIE ET AL., *supra* note 7, at 699.

<sup>243</sup> It is unknown by the author whether Wendy's International Inc. had a Shareholder's Rights Plan in effect at the time of Pershing or Trian initial investments. This example is used as a demonstration of how the Rights Plan could affect the hedge fund's objective.

<sup>244</sup> Trian 13D, *supra* note 236.

an incentive to enter a proxy contest if it had acquired many shares in Wendy stock for a loss.<sup>245</sup>

An interesting twist to Trian's investment in Wendy's would have been if Trian had decided, instead of selling put options, to purchase into a straddle. A straddle position means the fund manager has purchased the same number of call options as put options, and that all of the options have the same strike price and expiration date.<sup>246</sup> The straddle investment would allow Trian to make a profit as long as the price of Wendy's stock rises or lowers enough to compensate Trian in excess of the price already paid for both the call and the put options.<sup>247</sup> For this strategy, Trian could only lose money if there is little or no movement in the stock price.<sup>248</sup> Hypothetically, had Trian only invested in a straddle position it could profit without concern for either a poison pill or proxy contest. Under this theory, if Trian had exercised its call options it would have assumed a large enough position to trigger a poison pill, and it would have been completely hedged against any losses to the subsequent share price due to the hedge provided by its put options.<sup>249</sup> This strategy creates a disincentive to boards who might consider using a poison pill in an attempt to deter activist hedge funds: the board cannot predict with great certainty the true economic effect activation of the pill has on share price. Thus, activist hedge funds could seek large profits from stagnant stocks by purchasing a hedged straddle cheaply, by taking advantage of the call and put options' low implied volatility,<sup>250</sup> and merely proposing radical corporate change to increase shareholder wealth.<sup>251</sup> The result, regardless of the market reaction (negative or positive) to the fund's proposal, would leave the fund with a substantial profit.<sup>252</sup> This could be done without the fund ever concerning itself with the threat of the poison pill or ever having to take on the expense of a proxy contest.

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<sup>245</sup> This assumes that the value of the purposed corporate changes to Wendy's is less valuable than the profit Trian would have realized on exercise of its call options.

<sup>246</sup> Strike price is the price at which the holder has the right to, in the case of a call, buy the underlying security, and in the case of a put, sell the underlying security. The premium is the price paid for the option.

<sup>247</sup> See e.g., BODIE ET AL., *supra* note 7, at 715.

<sup>248</sup> *Id.*

<sup>249</sup> This example assumes both the call options are exercised prior to the expiration date and that there are enough call options available to trigger a poison pill.

<sup>250</sup> M. ANTHONY WONG, *FIXED-INCOME ARBITRAGE* 13 (John Wiley And Sons Inc. 1993).

<sup>251</sup> This theory ignores potential 10b-5 liability for market manipulation.

<sup>252</sup> This example assumes the fund has not misstated any public disclosures.

*D. Alternatives: SEC Regulation Which Would Enable Corporate Managers to Deter AED Hedge Fund Conduct*

Important issues surround the potential conduct of AED hedge funds, as highlighted at the end of the last section. Is this “activist behavior” appropriate or should there be SEC regulation governing AED hedge fund conduct?

The proxy contest, regardless of who provides the insurgent management slate, provides shareholders with an opportunity to expel entrenched management. Given that the value of their shares depends upon how well the corporation will be managed, it is appropriate to allow shareholders to dictate whose policy they prefer by selecting board members from either incumbent or insurgent board member lists. Therefore, the proxy contest should not be changed through additional regulation.

Poison pill plans are powerless as a threat to slow or stop AED hedge funds from behaving the way they please. Furthermore, without an effective way of preventing activist behavior, corporate boards have little choice but to seriously consider the proposals made by the fund manager. This leaves board members in a precarious position because they already must maximize shareholder wealth, but if they disagree with a proposed structural change that is favored by the shareholders, they face the possibility of being removed from the board. In effect, this allows shareholders to make the major strategic decisions previously entrusted to the board.

Corporate management is neither able nor willing to substantially limit the rights of their shareholders. Therefore, new SEC regulation or market reactions are the only ways to prevent or change AED hedge fund conduct. Should the SEC choose to restrain AED hedge fund activity by burdening the hedge fund industry with regulation, the same conduct would most likely be pursued, merely through a different means.

Alternatively, if the SEC were willing to limit the scope of its current disclosure regulations, corporate management would be free to curb AED hedge fund activity. Through an SEC amendment to Regulation FD, corporate boards may have the flexibility to curtail fund conduct.<sup>253</sup> Regulation FD prevents corporate management from making selective disclosures of material non-public information to institutional investors.<sup>254</sup> If the regulation were amended to allow corporate management to disclose material non-public information to a substantial institutional shareholder, corporate management could use non-public information as an affirmative

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<sup>253</sup> Regulation FD, 17 C.F.R. § 243 (2004).

<sup>254</sup> 17 C.F.R. § 243.100(a) (“whenever an issuer...discloses material nonpublic information regarding that issuer...to any [institutional investor] the issuer shall make public disclosure of that information”).

defense to an AED hedge fund. Coupled with the SEC amendment, the board must have the power to ratify the corporate bylaws under the state of incorporation's corporate code.<sup>255</sup> The ratification to the bylaws of the corporation could include language requiring any substantial shareholder making a formal proposal of a structural change to the corporation to participate in the board meeting that followed the proposal(s). As long as the information disclosed in the board meeting was material, the AED hedge fund would not be able to actively trade in the securities of the corporation until the material information was disclosed to the public.<sup>256</sup>

The proposed amendment to Regulation FD raises several additional issues, including: is any potential harm caused by the changing of current SEC regulation a justification for deterring AED hedge fund activity? Are directors in breach of fiduciary duty for amending bylaws with the intention of preventing activist fund/shareholder behavior? Finally, is a temporary block on trading the target's securities enough to deter AED hedge funds? Obviously, the proposed SEC conduct is not without issue; it is meant as a mere demonstration of behavior the SEC could perform that would impact activist hedge fund strategy.

## V. CONCLUSION

The exponential growth of hedge funds has presented the SEC with several difficult regulatory issues. The SEC's primary response to the growth and retailization of hedge funds has been to require the registration of hedge fund advisers. Innovative hedge fund investment strategies are constantly evolving, however, which may present additional regulatory challenges for the SEC, as evidenced by the activist event driven strategies now being utilized by hedge fund advisers. One certainty is that the hedge fund industry will continue to present challenges to Christopher Cox, the new chairman of the SEC, as the commission begins the implementation of hedge fund registration and attempts to keep pace with the ever evolving investment strategies utilized by sophisticated and innovative hedge fund advisers.

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<sup>255</sup> The Model Business Corporation Act and the General Corporate Law of Delaware (as well as many states) already allow this conduct in sections 10.20 & 141, respectively.

<sup>256</sup> *Dirks v. Sec. Exch. Comm'n*, 463 U.S. 646 (1983).